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Central Intelligence Agency



Washington, D.C. 20505

## DIRECTORATE OF INTELLIGENCE

21 June 1985

China: Coping With Accelerated Growth [REDACTED] 25X1

Summary

China's first-quarter 1985 industrial output increased 23 percent over the same period last year, according to official Chinese statistics. We believe the rapid industrial growth was caused by surges in personal income and investment spending as well as by production adjustments related to economic reforms and technical modernization of Chinese industry. Although welcoming rapid growth as an indicator that industrial reforms are achieving success, Chinese officials worry that the high growth rate will aggravate shortages of energy and raw materials, strain transportation facilities, and add to inflation. [REDACTED] 25X1

Beijing has employed a combination of administrative measures and Western-style macroeconomic adjustments to try to bring the overheating economy under control, and reform proponents thus far have been able to manage the problems arising from the reforms while continuing to advance their agenda. Lack of experience in managing a decentralized economy, strong desires by local officials for quick economic results, and large private holdings of cash suggest to us, however, that China's economic mandarins may not be able to control the economy as well as they hope. [REDACTED] 25X1

First-Quarter Economic Performance

China's industrial output in the first quarter increased 23 percent over the same period last year. This continues a trend

This memorandum was prepared by [REDACTED] Domestic Policy Branch, China Division, Office of East Asian Affairs. Comments of questions are welcome and should be addressed to Chief, China Division, OEA [REDACTED] 25X1

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of double-digit growth in industrial output that began in 1983 and accelerated during the second half of 1984. With industrial production growing 10.5 percent in 1983, 14 percent overall in 1984, and 18 percent in the fourth quarter of 1984, China probably has the fastest growing economy in the world.<sup>1</sup> Unlike seasonal production patterns in past years, the total value of industrial production in the first quarter of this year was almost the same as that of the fourth quarter of 1984.

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The growth rate for light industry probably slightly exceeded the rate for heavy industry during the first quarter. January and February figures indicate growth rates for light and heavy industry of approximately 26 and 21 percent, respectively. China's southern coastal provinces had industrial growth rates two to three times higher than those in the northeast. Industrial production in Zhejiang, Fujian, and Guangdong increased by more than 30 percent in the first quarter, while growth rates for Heilongjiang, Jilin, Liaoning, and Tianjin municipality were approximately 11 to 15 percent. Production of mining equipment, metal-cutting machines, and small tractors grew at rates above the 23-percent national average, and the production of motor vehicles increased at a 60-percent annual rate. The steel, energy, and transport sectors, however, expanded at lower rates than the overall industrial growth rate. Coal and oil production increased 10.3 percent in the first quarter while electrical power generation was up 8 percent. According to a Hong Kong newspaper controlled by Beijing, steel output increased 6 percent in the first quarter.

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Total retail sales increased 32.7 percent in the first quarter, and strong consumer demand sustained a boom in the production of electrical home appliances. Output of washing machines, electrical fans, and air conditioners increased nearly 100 percent, and production of refrigerators more than doubled.

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### Do Chinese Statistics Overstate Growth?

Although we generally have confidence in Chinese production statistics, we believe the recent figures may overstate Chinese industrial performance for a number of reasons:

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<sup>1</sup> According to Chinese statistics, industrial production increased at an annual average rate of 7.9 percent from 1979 to 1983.

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- Enterprises increasingly purchase semifinished goods and industrial components from other firms rather than manufacture the inputs themselves, and these transactions now may be recorded in calculations of overall industrial output.
- Chinese calculations of real growth may not be adjusted adequately for price increases of some products.
- Beginning this year, Beijing is recording the output of village industries in the industrial output total, instead of in the agricultural output total. Because village industries are the most rapidly growing sector in China's economy, the new accounting method may give a somewhat higher growth rate for industry than would have been recorded before. Industrial output in 1984 increased 14 percent, but the new accounting method would have yielded a growth rate of 15.9 percent.
- The production of low-quality goods continues to be a problem. Not all new industrial output is sold.
- Some production figures may be exaggerated by local officials and enterprise managers.

Nevertheless, we believe the economy is growing at a very rapid pace, albeit somewhat slower than Chinese figures indicate. [ ]

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#### What Is Causing the Rapid Industrial Growth?

Chinese leaders credit recent industrial reforms--such as decentralizing management and linking remuneration of workers to enterprise output--with facilitating the high level of production, while also acknowledging that much of the rapid growth is demand driven. Beijing points to large increases in personal income and investment spending in particular, as key factors in prompting the strong industrial performance. [ ]

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According to a PRC-controlled Hong Kong newspaper, urban wage bills shot up 40.6 percent and bonus payments by state-run enterprises grew 104 percent during the first quarter, while capital investment rose 33.1 percent. The first-quarter surges followed a 19-percent increase in wages and bonuses and a 21.8-percent increase in capital investment in 1984. Much of the growth in income and investment spending in 1984 was funded by bank loans. According to Chinese leaders, currency in circulation increased 8 billion yuan more than planned last year.<sup>2</sup> [ ]

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Beijing also attributes rapid industrial growth to past investment decisions and rural reforms. The Chinese media claim that the economy is experiencing the results of high levels of investment in the energy and transport sectors, as well as plant renovations and adoption of new technology. Bumper harvests from rural reforms have increased the availability of raw materials for industrial use, while increasing rural incomes and fueling consumption demand. [REDACTED]

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We believe the rapid industrial growth has been caused by surges in personal income and investment spending and also reflects successful agricultural reforms that have been implemented during the past six years. China's economy probably has benefited also from efficiency gains caused by the appointment of better educated, technically competent managers and Beijing's increased emphasis on enterprise profitability. The high level of production has been facilitated by increased enterprise flexibility in selling over-quota production at prices above the state-set levels. To a lesser extent, rapid growth may have been caused by recently implemented industrial reforms and the technical modernization of Chinese industry. [REDACTED]

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#### Beijing's Reaction to the Rapid Growth

Although welcoming rapid growth as an indicator that urban reforms are on track, Chinese leaders have expressed concern that the growth rate has been excessive during the last few months. Premier Zhao Ziyang, Vice Premier Tian Jiyun, and State Councillor Song Ping, among others, have called for slowing the growth rate to a pace that can be supported over the long run by China's energy supplies, transportation facilities, government revenue, and foreign exchange. [REDACTED]

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Media commentaries and remarks by senior officials suggest that Beijing is uncertain how to weigh the relative importance of strong demand for commodities and supply-side adjustments in explaining the rapid industrial growth. Zhao stated recently that the government is studying whether the rapid growth is normal or abnormal. Rapid growth, apparently, would be considered normal if it were caused by efficiency gains achieved from reforms, but would be abnormal if it were caused by the unanticipated surge in the money supply or excessive production of substandard or unsalable goods. [REDACTED]

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<sup>2</sup> Table 1 lists key economic indicators for 1984 and the first quarter of 1985. [REDACTED]

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Dangers of Rapid Growth

We believe Beijing is extremely concerned that a continuation of rapid industrial growth will exacerbate long-standing problems in the economy--such as energy and transportation shortages and the use of wasteful production techniques--and undermine reform efforts. Despite impressive increases in the production of coal, oil, and electricity in the first quarter, **energy** supplies are strained. Additions to the **transportation** network have not kept pace with the growth in industrial output and the system remains seriously overburdened. Chinese media report that factories still must suspend production occasionally to wait for electricity and raw materials. [REDACTED]

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Beijing acknowledges that high output in some cases is caused not by efficiency gains but by the **use of large amounts of inputs**. According to press reports, some enterprises have put their workers on extra shifts or allowed them to work longer hours. Other reports warn of overconsumption of raw materials, or what the Chinese call "eating next year's food today." [REDACTED]

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We believe Beijing is worried that undue emphasis on achieving high growth rates will cause a **wasteful use of resources**. In fact, Chinese media report that unit production costs in some industries have risen. Deficits incurred by enterprises during January and February increased 5.8 percent over the same period last year. A dramatic example of the dangers inherent in pursuing overly ambitious output targets occurred at a Henan Province coal mine when attempts to double output caused newly installed equipment to break down from overloading--thereby interrupting production for nine days and causing a loss of about 1 million yuan. Press reports suggest that rapid growth also is wearing out equipment at excessive rates, exhausting workers, increasing occupational hazards in factories, and generating higher levels of environmental pollution. [REDACTED]

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According to Zhao, recent output levels were possible only because China **imported large amounts of raw materials**. Imports of rolled steel last year, for example, were equivalent to one-third of China's total steel production for the year, yet China's machinery industries still face shortages of rolled steel, as well as pig iron, copper, zinc, and other raw materials. High levels of imports, moreover, are depleting China's foreign exchange holdings. [REDACTED]

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Beijing recognizes that its industrial development cannot be based on imports of raw materials and equipment--rather, energy, transport, and raw materials constraints must be solved

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internally. Major goals of industrial reforms are to increase managerial efficiency and labor productivity to make better use of existing resources. Some of the forces driving China's rapid growth, however, are undermining these reform goals. [REDACTED]

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Although industrial output has increased rapidly, it is not sufficient to meet the high demand for consumer goods, equipment, and building materials caused by the surge in personal income and capital construction during the last six months. **Rising prices** fueled by excess demand for finished goods and raw materials threaten to jeopardize public acceptance of price reforms--a crucial element in the reform program. Additionally, the threat of bankruptcy is still not sufficiently strong to force enterprises to produce quality consumer goods. A survey of 400 state-run enterprises showed that, as of December 1984, about 20 percent of stockpiled consumer goods were unsalable because they were overpriced and of poor quality. Press reports emphasize repeatedly that **low product quality** remains a serious problem.

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Beijing seems especially concerned that recent economic successes may have induced enterprise managers and local and provincial officials to set **unreasonably high production targets**. Three years ago Beijing set the goal of quadrupling the value of China's 1980 output by the year 2000. The Anhui provincial government, however, recently established the goal of doubling the output value of town and village industries this year, and Liang Lingguang, governor of Guangdong Province, was quoted earlier this year as saying that per capita income should quadruple in Guangdong by 1990. According to media reports, some localities have set the targets of doubling their output value by 1987 or 1988 and increasing 1980 output value eightfold by the end of the century. [REDACTED]

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Although downplaying the extent of the problem, recent editorials have warned that, if officials set unreasonable output targets, enterprise managers may resort to **falsifying production data**. We believe Beijing is concerned that, if the practice spreads, it will become increasingly difficult to judge how well control measures are working. [REDACTED]

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#### Measures to Slow Growth

Beijing has reacted quickly to cool the overheating economy, implementing a combination of administrative controls and macroeconomic adjustments. Beijing has also employed moral suasion by publicly exhorting enterprises and localities not to blindly pursue high growth rates. To emphasize its concern it has invoked the specter of the Great Leap Forward, during which efforts to meet absurdly high output targets caused economic collapse and starvation of millions of peasants. [REDACTED]

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Many of the tools China has used recently to reduce consumer demand and investment spending are similar to those used in Western economies for macroeconomic management. In the first quarter, China began pursuing a tight money policy and announced its intention to slow the rate of growth of government spending, reduce administrative expenditures by government units, and narrow the budget deficit. [REDACTED]

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Lacking the highly developed financial system necessary for open market operations, Beijing absorbs excess currency by selling goods from state-run stores. According to press reports, the Ministry of Commerce has already spent \$1 billion to import consumer goods, including 2 million color TVs, 500,000 refrigerators, 400,000 washing machines, and 300,000 tape recorders. The state reportedly has drawn another \$1 billion from foreign exchange holdings to import trucks, cars, and chemical fibers. The Ministry of Commerce expects to withdraw an additional 3.5 billion yuan from circulation by marking down prices of overstocked domestic commodities and selling them to the public.<sup>3</sup> [REDACTED]

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In April, Beijing raised interest rates on time deposits held by individuals and enterprises as another means of absorbing excess currency. Rates on loans for working funds and capital construction also were raised, and officials have stated their intention to raise rates for other types of loans soon. [REDACTED]

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Beijing plans to exercise better macroeconomic control by strengthening the powers of the banking system and the People's Bank of China, its central bank, in particular. The People's Bank will now set quarterly credit limits for its branches and the specialized banks, and banks are urged to generate additional funds by acquiring new deposits or inducing borrowers to speed up repayment of old loans. Banks have been ordered to stop offering loans to inefficient enterprises and firms that produce poor quality products for which there is little demand. No loans are to be extended for capital construction projects whose spending exceeds the state quota or for projects not listed in the state plan. Banks now require enterprises and individuals to pledge

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<sup>3</sup> Some Chinese officials have complained recently that China has spent too much foreign exchange on consumer goods and not enough on high-technology imports, while press reports suggest that Beijing is concerned with a rapid drawdown of its foreign exchange reserves. To absorb excess currency in the future, we believe that Beijing will emphasize sales of domestic goods from state-run stores. [REDACTED]

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collateral equaling as much as 50 percent of the value of the loan. Banks also have been ordered to make a better effort at collecting overdue loans, and a new regulation allows banks to acquire the pledged collateral if the borrower cannot repay the loan. [REDACTED]

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To prevent indiscriminate increases in wages and bonuses, enterprises must now establish special bank accounts for their wage funds, which will be monitored by the banks. Beijing has also ordered more rigorous efforts to recover taxes on worker bonuses from enterprises and has suggested that it will implement a tax on personal income above a designated level. Since 1 April no departments or work units have been allowed to increase their payrolls, and changes will not be permitted until the planned wage reforms are implemented in July. [REDACTED]

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### Outlook

We believe Beijing's reaction to the overheating economy and the widespread problems--such as price gouging, smuggling, and black-marketeering--that have arisen during the last six months is qualitatively different from its reaction to problems in the past.<sup>4</sup> Beijing has expressed its determination to slow the economy gradually, using what it hopes are carefully calibrated macroeconomic policies, while strengthening oversight and control without backtracking on fundamental reforms. [REDACTED]

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In recent weeks reform proponents have pushed their agenda forward, calling on cadre to hold firm in the face of problems. Since April Beijing has implemented politically sensitive hikes in food prices in Beijing municipality and other major cities; raised short-haul railroad rates for passengers and freight; freed prices of sewing machines, watches, and some brands of bikes; pressed ahead with reforms in enterprise management; and announced its intention to implement sweeping wage reforms in July. [REDACTED]

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We believe that, in the transition from a centrally planned system to a more market-oriented economy, China may experience the weaknesses of both. Chinese leaders anticipated problems during the transition period; in his report to the National People's Congress (NPC) in March, Zhao bluntly stated that problems arising from reforms can be solved only through further

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reforms. Many of the problems that have arisen in the last six months result from the fact that managerial autonomy has been increased but reforms have not progressed far enough to allow the market to discipline enterprises that make poor choices. Last year managers were given more latitude in rewarding workers, but because the state still pays operating expenses of firms that lose money, managers were able to increase wages without worrying about bankruptcy. Likewise, banks were given enhanced freedom to extend loans but enterprises did not face bankruptcy if they failed to repay them. Beijing recognizes the need to allow firms to go bankrupt, but the present system of irrational prices makes it difficult to determine which enterprises should be closed. [ ]

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As Beijing approaches a crucial party conference in September, reform leaders will be under intense pressure to demonstrate that they can manage the economy using economic levers such as interest rates, credit, and taxes. We believe the control measures that have been implemented are generally appropriate, but a shared desire for rapid growth on the part of workers, managers, and local officials may make it more difficult to slow the economy than Beijing anticipates. Promotion of 10,000 yuan households by the media last year and admonitions to "get rich" through hard work have generated rising expectations among workers for an increase in their standard of living. Many local officials view "reform" as synonymous with rapid growth in output and pressure enterprise managers to prove their competence by increasing production. Suspected large cash holdings by peasants and expectations of rising prices may keep consumer spending high for some time, even though Beijing has claimed some success in reducing the money supply. [ ]

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It is also possible, but less likely, that in trying to slow the economy Beijing will decrease demand too much and bring growth to a quick halt. Beijing not only lacks experience in managing a more market-oriented economy, but the responsiveness of enterprises and consumers to macroeconomic adjustments may be changing as the reforms proceed. [ ]

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We expect China's real growth rate this year will be slightly higher than last year's 12 percent, while industrial production should be substantially above the 8-percent growth target established at the NPC. Nevertheless, we believe it is premature to say that the Chinese economy is at a "takeoff" stage of economic development. Unless China can deepen efficiency gains by successfully implementing industrial reforms, rapid industrial growth will deplete government revenues and foreign exchange holdings, and energy and transport shortages will exacerbate inflation. Most of the industrial reforms--especially price reforms and the opening of 14 cities and other areas on

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China's coast to Western business--remain controversial and unproven, and therefore vulnerable to political setback.

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Table 1

Economic Indicators  
(Rates of Growth)

	<u>1984<sup>1</sup></u>	<u>4th Quarter</u> <u>1984<sup>2</sup></u>	<u>1st Quarter</u> <u>1985<sup>3</sup></u>
Industrial Production	14	18	23
Bank Loans	28.9	17	
Total Wages (including bonuses)	19	46	40.6
Bonus Payments	48.1		104
Fixed Asset Investment	22		33.1
Capital Construction (State-owned enterprises)	23.8		

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<sup>1</sup> Percentage increase from 1983.

<sup>2</sup> Percentage increase from 4th quarter 1983.

<sup>3</sup> Percentage increase from 1st quarter 1984.

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